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Article

Financial Stability Board: Mandate and Implementation of Its Systemic Risks Standards

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Abstract: The aim of this essay is to provide an overview of the Financial Stability Board's (FSB) mandate and tools to safeguard financial stability and reduce systemic risks based on the methodological perspective of a legal analysis. It examines some of the recommendations that the FSB has published, with the aim of enhancing financial stability. In the second part of the paper, the complex problems that arise from implementing soft law recommendations, and the discretion granted to regulatory authorities, are discussed.

Keywords: best practices; compliance; FSB; soft law; systemic risks

1. Introduction

Today financial markets are global, impacting not only national economies but financial systems worldwide. In contrast, regulatory action has remained largely local. Only in recent years governments have intensified their work to coordinate regulatory efforts in order to overcome common problems in their respective financial markets. The Global Financial Crisis (GFC) for instance led to the conviction that coordinated actions of key international bodies are vital in order to avoid future turmoil in the financial sector.

The Basel Committee on Banking Supervision (BCBS) as well as the Financial Stability Board (FSB) are two such key international bodies. In April 2009 the FSB's tasks were reinforced by the G-20 at its summit in London and have since been further refined [1]. Both institutions aim at ensuring financial stability, yet they utilize different instruments based on their composition and mandate.

The following essay examines the objective of the Basel III-framework and the standard-setting activities of the FSB, as well as the problems that arise from implementing the FSB's recommendations into national law based on the methodological perspective of a legal analysis.

2. Importance of Addressing Systemic Risks in Financial Markets

2.1. Elements of Systemic Risks

In its report to the G-20 Finance Ministers and Central Bank Governors the FSB, the International Monetary Fund (IMF) and the Bank of International Settlement (BIS) define systemic risk as “a risk of disruption to financial services that is: (i) caused by an impairment of all or parts of the financial system; and (ii) has the potential to have serious negative consequences for the real economy” [2].

The reason why international bodies are concerned with systemic risks is the fear that the problems of one financial institution may spread and infect other financial institutions (so-called contagion) or, eventually result in the breakdown of the whole system [3]. Systemic risks can thus be created through the actions of various market participants, ultimately leading to the accumulation of risks by an actor who is not able to bear such risks on its own and whose bankruptcy would lead to severe disruptions in the financial systems; thus potentially further endangering other market participants.

Systemic risks are closely linked to the problem of too-big-to-fail [4]. In essence too-big-to-fail means that governments around the world cannot risk the insolvency of systemically important financial institutions (so-called SIFIs). The GFC has caused numerous state bailouts and government interventions aimed at preventing a system-wide contagion of the financial system and a drying up of capital markets.

2.2. Market Confidence and Pro-Cyclical Behavior in Particular

Financial market participants will only fulfill their functions and obligations as long as they are confident that their counterparties will do the same. Once market confidence is disrupted through the failure of a party (its non-performance of an obligation), others will no longer rely on the promise of market participants to perform, but will reduce their risk exposure as quickly as possible. In doing so, the whole financial market can break down, if at once all market participants flee out of an asset class, stop lending to third parties, or otherwise reduce risk in a manner affecting the market price of the asset [5].

Likewise pro-cyclical behavior, evidenced by a uniform reaction to a market event by all investors, must be counteracted as it leads to illiquidity on the financial markets which would further intensify a crisis ([6], p. ii). In order to prevent such a result, natural diversity in the market has to be maintained by allowing various risk management, valuation and accounting systems in conformity with the individual investor type. The flexibility created through these diverse systems enables market participants to react to a market situation in accordance with their liquidity needs. Long-term investors without short term liquidity requirements are capable of buying in a market in which others require liquidity. They do not have the short term cash flow needs which, according to accounting standards, would require them to hold only very liquid assets. Thus, due to the participation of long-term investors in the market, trading can take place without state action. Furthermore, the price of an asset can still be ascertained on the market as it remains to be traded based on the rules of supply and demand.

3. Activities of International Financial Organizations

Before going into the substantive issues, the organizational aspects and the mandates of the primarily involved bodies are to be analyzed.

3.1. Basel Committee for Banking Supervision and Basel III Framework

The Basel Committee for Banking Supervision (BCBS) consists of national financial regulators from 27 countries. It was created as a powerful standard setter in 1974, long before the Financial Stability Forum (FSF) or its successor, the FSB, came into existence. At the core of its functions lies the improvement of banking supervision worldwide. In contrast to the FSB, the BCBS focuses on the regulation of banks for institutional reasons and disregards other financial intermediaries [7].

3.1.1. Functions and Mandate

It is an international informal law making institution as mainly public actors are involved in its decision-making processes and the rules advocated are not legally binding (*i.e.*, not based on a treaty) [8]. Generally this form of law making is more flexible and adaptive to changing circumstances and in achieving specific regulatory goals. However, it attracts accountability problems if no form of review (*i.e.*, through a court) is available.

At the heart of the BCBS's mandate lies the so-called Basel framework which sets the requirements of an adequate capital level for financial institutions. During the GFC, the weaknesses of the Basel II framework, which increased the severity of the crises, came to light. In particular, the core philosophy of risk-calibrated capital was heavily criticized as it allowed banks to calculate their risk themselves and only required approval by an often inadequately equipped national regulator. Also the narrow focus of the framework has been highlighted as it did not take account of all the underlying risks of subprime mortgage loans. In essence, only the actual investment and its securitization were part of the required Basel II risk analysis. The broader effects of sub-prime loan defaults on other asset backed investments were not taken into account [9].

In addition to the mentioned capital standards, the Basel III framework also advocates the use of Central Counterparties (CCP) for Over the Counter (OTC) derivative products. This approach is aimed at reducing systemic risk by way of monitoring OTC contracts which now must be cleared by a CCP. Through CCP, any dangerous accumulation of exposure can be identified and third party transaction risks reduced.

3.1.2. BCBS Members

Twenty five BCBS member countries passed the final set of Basel III base capital regulations. Also Turkey and Indonesia are in the process of finalizing their draft regulations. Most notably the United States and the European Union have approved Basel III regulations, thus all of the banks which are defined as global systemically important (so called G-SIFIs) are now in a jurisdiction in which the Basel III standard applies, or is being implemented [10,11]. Until recently, within China, the BCBS only classed the Bank of China as globally systemically important [12]. However, the updated assessment conducted in November 2013 expanded the list of Chinese banks by including the Industrial

and Commercial Bank of China Limited [13]. By 2016 the G-SIFIs must meet the BCBS Principles on Effective Risk Data Aggregation and Risk Reporting, which includes effective information system management for efficient and reliable risk reporting. Such systems must be able to function even in times of crisis, thus allowing for a timely and flexible risk reporting, tailored to the recipient's needs. Furthermore, they are required to cover all corporate activities, including subsidiary entities [14].

3.2. Financial Stability Board and Its Mandate

In April 2009 the FSB succeeded the FSF which had been established in 1999 to overcome fragmentation across International Standard Setting Bodies (ISSB) and to coordinate international standard setting in the field of financial regulation [1]. The FSB was created in the wake of the GFC to provide a more structured approach through its institutional framework to the global regulatory efforts. Despite not passing any binding legislation at the G-20 summit, the Member States strengthened and refined the FSB's role through various declarations [15]. The G-20 thereby acts as coordinator between various financial networks, spanning institutions such as the International Monetary Fund (IMF), as well as the BCBS ([16], p. 553). For the G-20, facilitating the creation of a global accounting standard is also of central importance, as the accounting standards used in the United States, and approved by the FSF, contributed to the GFC. Currently the International Standard Setting Bodies (ISSB) are trying to bridge the gap between the European IFRS and the US-GAAP standards ([7], p. 686).

3.2.1. FSB Primary Mandate

The FSB's main objective consists in reducing systemic risks by enhancing the quality and coherence of standards set by, e.g., the Basel Committee and the International Organization of Securities Commissions (IOSCO), as well as improving their application through the IMF and Worldbank [17]. A second central function lies in the supervision of systemically important financial institutions of which the financial and operational structures as well as the funding arrangements are continuously monitored. The FSB also shares the information gained in the course of such an assessment with its members and supports contingency planning for a potential failure of a financial institution.

As the third pillar of its mandate, the FSB conducts peer reviews into its Member States' regulatory framework in order to evaluate potential risks. The results of which are subsequently published in reports containing recommendations to improve a state's financial regulation [18]. In doing so, the FSB highlights necessary institutional changes aimed at strengthening regulatory powers and suggests new regulatory frameworks or adjustments to the existing ones, in order to address identified areas of concern. Additionally, the FSB members have also committed themselves to undergo the IMF's Financial Sector Assessment Program (FSAP) which reviews the Member States' financial systems every five years [19].

3.2.2. Specific Functions

According to the FSB's statement its mandate currently includes the following functions [20]:

1. assess vulnerabilities affecting the financial system and identify and oversee action needed to address them;

2. promote co-ordination and information exchange among authorities responsible for financial stability;
3. monitor and advise on market developments and their implications for regulatory policy;
4. advise on and monitor best practice in meeting regulatory standards;
5. undertake joint strategic reviews of the policy development work of the international standard setting bodies to ensure their work is timely, coordinated, focused on priorities, and addressing regulatory gaps;
6. set guidelines for and support the establishment of supervisory colleges;
7. manage contingency planning for cross-border crisis management, particularly with respect to systemically important firms; and
8. collaborate with the IMF to conduct Early Warning Exercises.

Nevertheless, it does not possess any direct power to force regulatory change on a member ([21], p. 265). In order to facilitate the realization of a certain degree of uniformity the FSB is given the power of international informal law making within its mandate. It uses the data gained from the peer-review process to achieve its mission by exerting political compliance pressure on the member state in question through its recommendations.

Generally, the FSB's recommendations for its Member States include the streamlining of regulatory oversight by clearly designating the responsibilities of each government agency responsible for the oversight of prudential regulation. Strengthening the data collection and increasing the resources necessary to identify risks are also part of the core recommendations. Prudential regulation is aimed at preventing the development of systemic risks, in order to maintain the stability of the financial sector [22]. Due to its uniform application within a state it is a core mechanism in achieving a stable financial system. It encompasses rules relating to capital adequacy, liquidity, and consolidation ([23], p. 246). Furthermore, efficient prudential surveillance of all market participants requires the collection of relevant, confidential and up to date information [24].

3.2.3. Membership Status

There are three categories of FSB membership status. The first and main actors are the Member jurisdictions (the G-20 countries plus Hong Kong, the Netherlands, Singapore, Spain, Switzerland and the European Central Bank as well as the European Commission) followed by the International Standard-Setting, Regulatory, Supervisory and Central Bank Bodies (BCBS, CPSS, CGFS, IASB, IAIS, IOSCO). The third category comprises selected International Financial Institutions (IMF, World Bank, BIS, OECD). Between these three categories of membership only the member jurisdictions are under a commitment to pursue the maintenance of financial stability, maintain an open and transparent financial sector, implement international financial standards and undergo periodic peer reviews [20]. The standard setting bodies report to the FSB on their work, whereas no form of commitment is imposed on the International Financial Institutions (IFI). However, the possibility of allowing external *ad hoc* consultation with private actors has attracted some criticism as it leaves the FSB open to private influences, potentially conflicting with its goal to ensure financial stability. As generally the influence of private actors must be kept to a minimum in order for the FSB and other regulators to maintain their independence, safeguards, such as public disclosure of relationships, as well as fixed timeframes before an individual can move into lobbying should be implemented.

In contrast to the previous FSF membership, due to the expansion, the FSB now represents nearly all of the regulators of the 50 biggest banks in the world as well as nearly 80% of the world savings. Nevertheless, the representation in the plenary is based on the greatest combined political and economic influence. The input is therefore mostly dominated by a few economically strong countries ([21], p. 266). The seat allocation ranging from one to three seats is determined based on each member's economic size, its activity in the financial markets and its national financial stability arrangements (measured in terms of adherence to international standards, participation in evaluation programs and the level of disclosure) [25]. Broadening the scope of the FSB's membership and putting in place a democratic and representative election procedure addresses some of the legitimacy and authority concerns raised during the FSF period [26]. However, due to the strong differences in economic and political power, only a few main actors dominate the agenda-setting.

Of great importance to the FSB's success are the members' cabinet level ministers which are strongly involved in the political processes in their home countries. This unique structure allows the FSB to act as an international standard setter for financial regulation as political will is brought to bear on the international decision making level through these ministers ([27], p. 4).

3.3. Development and Implementation of Standards by the FSB in Particular

Three standing committees and three *ad hoc* working groups are involved in the recommendation making process of the FSB. Each of them carries out specific functions which form the core of the FSB's work. Their membership is determined by a plenary vote and based on a recommendation by the chairman [25].

3.3.1. The FSB Committees

At a first stage, the FSB's Vulnerabilities Assessment Committee (VAC) identifies potential future risks to the financial system. It is headed by the General Manager of the BIS and its daily business is to develop models on how systemic risk evolves, as well as to assess the effects regulation has on various financial market participants.

The Supervisory and Regulatory Cooperation Committee (RCC) designs mechanisms and protocols to address the identified issues. In doing so, it is in contact with the main market actors and the business community to foster cooperation and better understanding of potential implementation issues. Nevertheless, no minimum standard to which a national regulator must adhere is set in the process. The Committees facilitate and encourage an open exchange of information on potential risks and how they can be combated.

Once the mentioned committees have identified risks and suggested regulatory measures, the most influential actor within the FSB in regard to the implementation of recommendations, the Standards Implementations Committee (SIC), commences its work. It prepares reports on the regulatory standards of the member countries which are submitted to all members for peer review. In doing so, sufficient political pressure is created requiring the state in question to take action in order to address the issues raised ([6], pp. 209–210). Although the IMF also conducts its FSAP which is used by the FSB, the scope of the SIC's analysis is much broader [28]. It focuses on a specific theme every year and is also concerned with gaps and inconsistencies in different regulatory frameworks ([21], p. 270).

In addition, the FSB's supervisory colleges overseeing the 28 largest financial institutions worldwide carry out the specific function of ensuring the financial resilience of these systemically important institutions. In fulfilling its obligations, the FSB coordinates with the national regulators by sharing information and conducting periodic stress tests. As the national regulator remains responsible for the institutions within its jurisdiction, the FSB can only recommend changes, but has no legal authority to force any action on a regulator or institution.

3.3.2. Decision-Making Process and External Influence

One should keep in mind that the FSB's work is heavily influenced by two main actors: The technocrats, on the one side, who try to achieve a financial regulation scheme which addresses the identified systemic risks, and the politicians on the other side, wanting to find a middle way between necessary financial regulation, economic growth and the desires of their constituents [29]. Because consensus is required between the Member States before changes or new measures can be realized, no groundbreaking recommendations are to be expected from the FSB [30]. Rather the required regulatory actions highlighted during a peer review process must have been previously agreed upon in the FSB's plenary meetings, thus they are already known to the members. It has, therefore, been argued that greater restrictions on the business practices that lay at the core of the GFC are neither part of the FSB's agenda nor could the required political consensus be reached [21]. Achieving an effective peer review system will require bridging the gap between accountability within the institution and power struggles external to the FSB, whilst ensuring collegiality and trust among the representatives of the Member States. Compliance with the recommendations made during the peer review process is dependent on a member country's perception of the FSB as an open, accountable and reliable institution. If such an impression can be maintained, the members will be more willing to commit to the FSB's recommendations. Taking a firm stance on members who only try to cherry pick the regulation they deem appropriate, is essential in ensuring the FSB's success.

3.3.3. FSB's Focus on Shadow Banking

In recent times, shadow banking has been brought into the focus of the FSB's attention. The term shadow banking can broadly be described as credit intermediation involving entities and activities outside the regular banking system ([31], p. 1). These entities conduct bank business without falling under the stringent financial market regulation or supervision. They amplify systemic risk because of their close connection to the banking system. In order to combat the risks associated with shadow banking, the FSB has developed a monitoring framework and highlighted five areas in which oversight needs to be strengthened. Several jurisdictions including Australia, Canada and Germany have published detailed analysis of their shadow banking system whereas non-FSB members have also conducted such reviews but chose not to publish them [32,33].

Importantly the review process is not only conducted with view to the FSB's members but also extends to Non-Cooperative Jurisdictions (NCJ). These NCJ are Non-Member States which do not comply with the FSB's standards of cooperation and information sharing. In order to encourage these jurisdictions to become compliant, positive incentives (*i.e.*, technical assistance) are offered by the

FSB. However, a public listing as non-cooperative jurisdiction and even sanctions by the FSB Member States are also theoretically possible.

3.3.4. FSB's Progress Analysis

The FSB has published a new progress report in September 2013 highlighting its main achievements, such as the increased capital standards and pointing out areas of improvement for example in the cross border resolution of SIFI [34]. The general message is that the steps taken are on the right path but the rate of change needs to be increased. Further effort is necessary to reach the goals set by the FSB in particular in the contested areas of cross border resolution and capital adequacy. Through the FSAP additional weaknesses in regulatory independence and resourcing of supervisory bodies have been identified. Only 25% of the jurisdictions are yet fully compliant in this regard, requiring stronger action by the member countries ([34], p. 21).

Gadinis' article in 2009 highlighted the FSB's success in influencing the BCBS to implement a leverage ratio for asset evaluation in addition to the above mentioned risk-calibrated capital ([27], p. 4). This demonstrates the ability and willingness of the FSB to push for necessary reforms.

Furthermore, the SIFI definition has been updated to extend the FSB's framework to financial institutions which are not banks but nonetheless pose a systemic risk for the financial systems ([34], p. 19). In expanding its scope, the FSB needs to ensure that it maintains consistency across non-bank entities to prevent unnecessary market distortion and to set the appropriate behavioral incentives. Additionally, nine systemically important insurers have been identified and requirements for them are currently being developed by the FSB of which finalization is planned to take place at the G20 summit in 2014.

In a 2013 report to the G-20 the FSB also pointed out that its goal to achieve improvements in the availability of long-term financing has not yet shown the results expected and that further momentum must be developed by the G-20 to increase the rate of reform ([27], p. 4). This is in line with Carrasco's view that the legitimacy of the FSB will depend on the substance and utility of its actions ([35], p. 118).

4. Mechanisms of Transformation of International Standards into State Law

4.1. Procedural Framework

In most cases the FSB's recommendations lead to the formal adoption of regulatory measures by the Member States. However, practice has shown that there is often a significant gap between formal adoption of the agreed international standards and real compliance in implementing the agreed measures [36]. Often countries do not publish compliance reports, thus making an assessment difficult. Especially the United States have shown reluctance in taking part in the IMF's FSAP which the FSB heavily relies upon in making its assessments and recommendations. The reason for the US not to contribute to the program is based in the weakness of its financial supervisory architecture, its delay in implementing the Basel Standards as well as the hugely different US-GAAP accounting system ([37], pp. 91–98). As head of one of the most developed countries in the world President Bush thought that the US should not take part in the program. This was further reflected by the national legislation on financial regulation omitting any reference to the FSB or international standards [38]. However, under the Obama administration a more open approach has become evident. The analysis of the GFC has

demonstrated that the regulatory failures in the developed countries formed the basis on which excessive risk taking could develop. Now it is up to the FSB Member States to show their willingness to carry out real reforms to prevent such market behavior in the future.

In addition to crisis prevention through appropriate financial reforms, further measures to stabilize and enhance financial development are required ([7], p. 654). Effective enforcement remains integral to any functioning framework [23]. Allowing the FSB's recommendations to be implemented in differing forms leaves considerable room for creative and individual interpretation which fosters legal uncertainty [39]. Despite these issues surrounding the implementation of the FSB's recommendations they can provide at least a basic benchmark for the behavior of market participants ([7], p. 661). Furthermore the GFC has provided the necessary momentum to encourage standard setters and regulators to take action in accordance with the international accepted framework of the FSB. These encouraging changes have been heavily influenced by the FSB thus going beyond the previous superficial FSF discussions.

4.2. Regulatory Discretion of Competent Bodies

In September 2013 the FSB issued its progress report, highlighting the successes so far and pointing out areas of further improvement. One of the critic points is that the implementation of reforms by some national legislators did not go far enough and requires further effort to comply with the key-attributes set by the FSB ([34], p. 6). These attributes relate to the resolvability of cross-border financial institutions and the resolution powers of national authorities. Additionally, the slow progress among the members in ending market participants' mechanistic reliance on external ratings remains a main critic point ([34], p. 9).

Granting national regulators the discretion to implement the recommendations into national law in accordance with their own needs carries the risk of potentially leading to regulatory gaps and a subsequent market distortion. This can be avoided if the regulations in different jurisdictions are aimed at achieving substantially similar outcomes. Otherwise regulatory arbitrage, evidenced by a movement of financial institutions into less regulated jurisdictions, will inevitably take place. Furthermore, national authorities are staffed by the national legislators and subject to budgetary restrictions resulting in a varying degree of supervision in the Member States.

In contrast to the FSF the FSB has made significant progress in achieving actual implementation of its recommendations. Especially the shorter meeting intervals, constant coordination and discussion among the member states and the implementation committees have proven to be highly effective. One should however not forget the complexity of the financial systems worldwide and the need for a steady and transparent transition into new regulation which requires time.

4.3. FSB Peer Review of Relevant Countries

The jurisdictions discussed below underwent FSB peer review in 2013 which assessed the strengths and weaknesses of their respective regulatory systems. In this regard, Zaring points out that these peer review processes have not been very formally structured, but he believes that this will change over time ([27], p. 9). As most of the FSB's member countries have been assessed a couple of years ago, progress as well as shortcomings can be highlighted.

4.3.1. USA

The United States responded to the FSB's recommendations, formulated during the London Summit in 2009, by passing the Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA) and establishing the Financial Stability Oversight Council (FSOC) in 2010. Its function is to coordinate macroprudential oversight between the various state and federal agencies and to promote financial stability. In line with its tasks the FSOC has identified 10 financial structures as systemically important. These institutions are subject to higher regulatory oversight by the Federal Reserve Board. In order to address concerns as to the availability and quality of financial market information, the Office of Financial Research (OFR) within the Treasury Department was founded. It supports the work of the FSOC by providing timely and accurate information on potential system wide risks and develops tools to identify them [40]. This progress is in line with the FSB's recommendations of establishing strong macro and micro prudential oversight whilst also ensuring the availability of timely and accurate data necessary for the functioning of these institutions.

However, the FSB also pointed out areas in which further improvements are necessary. Because of the diverse membership of the FSOC, including the heads of the main financial and insurance oversight bodies, the FSB needs to develop a clear framework which enables the member states to efficiently distribute the tasks for which the member state agencies are responsible. Additionally, the regulator must set out the review process for proposed legislation so as to ensure consistent treatment across all areas and agencies. Also, the narrow scope of the systemic risk assessments has been criticized and a more detailed and prioritized analysis requested. Furthermore, the communication between various parties should be conducted in a more targeted manner instead of only publishing one main report for Congress and the public. In regard to contingency planning the terms of the available lending arrangements are to be more precisely defined so as to list the collateral type required and the maximum amount of emergency funds available. Appropriate measures must be implemented to ensure a speedy and structured process for accessing short term emergency funding.

In general, communications between regulators worldwide should be improved as the SIFIs are increasingly internationally active. Oversight cooperation arrangements also form part of this increased communication which aims at ensuring compliance with the FSB's financial stability framework and preventing regulatory arbitrage. The United States' conduct is of fundamental importance for advancing the implementation of new standards as its behavior will have significant signaling effects on all other jurisdiction as well as on its own financial institutions doing business globally ([10], p. 8).

The FSB's interim Report on Reducing Reliance on Credit Rating Agency (CRA) Ratings published in August 2013 has highlighted the United States' successful stance on remodeling its rating framework, thus fulfilling the minimum standards advocated by the FSB. Under section 939A of the DFA the US legislator now requires the complete removal of CRA ratings and their replacement by other standards of creditworthiness as may be deemed appropriate in the individual case. This goes far beyond the initial recommendation by the FSB and sets an example for other FSB members. Although fulfilling a higher standard appears to be a good approach, at second view it might lead to unwanted and counterproductive results [41]. According to the CRA roadmap, by mid-2014 the policy recommendations will be published after an assessment is finalized as to how the new CRA framework can be implemented and reliance on CRA ratings reduced.

However, considerable ambiguity remains as to what the new alternative credit rating standards ought to entail. In taking steps to address this question the FSB has further issued six recommendations to its members which include the request for an assessment of the current conditions, the provisioning of incentives for market participants to conduct and disclose their own risk assessments, publication of an action plan (prioritizing areas of change) including fixed timeframes and a request to the standard setting bodies to provide further guidance.

In order to ensure consistent application of high quality accounting standards the USA has improved the banking regulators' monitoring efforts and ensured routinely meetings and liaison with audit firms, standard setters, financial institutions and the Securities and Exchange Commission (SEC). Especially finding common ground on fair value measurement has been the main topic of a recent joint IASB/FASB project. The ultimate goal is to implement the same valuation standard under GAAP and IFRS.

4.3.2. United Kingdom

In the UK's peer review, the FSB pointed out one of the core strengths of its recommendatory system. It allows for the necessary flexibility in implementing the required measures into the legal framework of each member country, thus making an individualized and more efficient approach possible. The structure chosen by the UK is closely linked to the Bank of England through the establishment of a new Financial Policy Committee (FPC), thus fits nicely into the existing framework. Additionally, the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) were created. The first acts as micro-prudential regulator, the second as business regulator. In establishing these distinct entities, the UK avoids issues that could potentially arise because of the institutions' differing focus on systemic and consumer protection ([37], p. 192). Despite these advances the system carries with it the risk of "group thinking" as the responsibility is shared only by a few executives. This concern has been taken up by the UK legislator which reacted by including external members on the Boards of the PRA and FCA.

The Financial Services Act (FSA) gives the FPC wide discretion in making recommendations to the PRA and FCA on how to counter systemic risks. It is yet unclear on how much influence the FCA can wield by drafting highly specific recommendations and, consequently, how substantial its power over the prudential framework and other agencies essentially is. This situation can create tensions within the framework as between the agencies and the FPC and result in confusion in the market.

Key to an efficient regulation is a forward looking and targeted supervision. The UK should improve its regulatory oversight by placing more emphasis on effective communication between front line supervisors and risk specialists and enhancing the technical expertise of the PRA and FCA members. This is of central importance as a great amount of the UK's banks have subsidiaries abroad which also need to be closely supervised and for which a risk expert's country specific knowhow is required. Human resource needs must be regularly evaluated to ensure sufficient manpower is available to oversee the implementation of the regulations. In particular smaller firms need closer supervision as they are mostly reactive and require reinforcement by the agencies' front-line staff. Also the risk in implementing a new supervisory framework and the required staff to oversee the transition should not be underestimated.

The FSB has also suggested flexible resourcing models for smaller firms to ensure an appropriate level of coverage whilst not placing an undue burden on them ([42], p. 11). They are assessed by the PRA on a portfolio basis. Despite their relative small size these firms can collectively pose a systemic risk. Flexible resourcing, with its largely reactive approach to financial oversight, might even encourage unwanted behavior. Thus the regulator should retain the resources necessary to ensure that they can be supportive of such small firms when the need arises. In light of the effects the insolvency of a small bank can have on the public's perception, one should not neglect these small firms simply because of their size.

Oversight over the Credit Rating Agencies has been transferred to the European Securities and Markets Authority (ESMA). A second regulation has recently been passed by the UK in order to meet the FSB's targets in developing measures to overcome reliance on CRA. However, the implementation of technical standards is an ongoing process. The FCA continues to collaborate with the IOSCO and ESMA's technical committees in refining these standards ([41], p. 30)

In a nutshell, the UK has made considerable progress in adjusting its regulatory system in increasing supervision and sending signals to the market participants that any unwanted risk taking will no longer be tolerated.

4.3.3. South Africa

Due to South Africa's complex regulatory structure the SA treasury decided in 2011 to shift to a twin peak model of financial regulation, in order to create a clear and independent framework. This model includes a prudential supervisor and regulator established within the South African Central Bank and a dedicated market conduct regulator aimed at improving oversight over the dominant financial conglomerates in South Africa. A newly conceived interim Financial Stability Oversight Committee (FSOC) shall be responsible for macro-prudential oversight of the financial system until the framework is fully implemented. However, because of the sharing of complex responsibilities between the various regulators many questions as to who is precisely responsible for which task remain.

Concerns have been expressed towards the effect the new regulation might have on the previously unregulated OTC market. Also the FSB has suggested implementing a strict timeframe for establishing the twin-peak model and other regulatory measures. Practical integration issues such as differences in pay structures, information technology systems, premises and corporate cultures among the different authorities must be adequately addressed and resolved. For the interim period, the powers and tools of the FSOC must be clearly set out to enable its proper functioning. Also harmonization and rationalization of the various laws applicable to the different types of financial institutions must be carried out [43]. Compared to the lack of action in the previous decade, however, the steps taken in South Africa can be seen as a direct result of the firm stance taken by the FSB and the realization of the need for reform.

4.3.4. Spain

In 2011 a peer review of Spain's financial regulatory framework was conducted which and subsequently set in contrast to a previous review carried out in 2006. The 2006 review pointed out various potential risks. These included the rapid credit growth in the housing sector and the exposure

of saving banks (cajas) to these credit risks. Positively the Spanish government has taken measures to ensure transparency in its assessment and evaluation procedures. Nevertheless, areas of improvement remain especially in relation to bank figures on debt to equity swaps [44]. In 2010 Spain conducted and published a financial stress test incorporating 95% of its banking sector, which so far has been the highest percentage of institutions analyzed in the EU. However, the risks associated with the cajas were only addressed very late, which again highlights the need for a timely response to recommendations derived from the FSAP ([44], p. 6). Compared to the previous lack of action under the FSF the changes undertaken since the establishment of the FSB are encouraging.

A central factor differentiating Spain from other countries lies in the cajas' investments in industry participations. These holdings subject the banks to potential conflicts of interest and create systemic risks due to the sums and high degree of risk involved. Furthermore, the FSB has raised concerns that regulators could be subject to political interference affecting their independence ([44], p. 7). Plans had been made to implement a twin peak model (one regulator for prudential supervision and one for market conduct) but these were suspended during the financial crisis. Similar to the other jurisdictions mentioned in this essay, the implementation of an efficient organizational structure has been strongly recommended by the FSB. Such a framework should clearly set out the powers and means of the institutions involved and allow them to take the measures required to maintain financial stability. The hope is that the Spanish government will take up the reform measures suspended during the crisis to address these issues. Transparency and the degree of stress testing will prove to be vital for further reforms. Nevertheless the actions taken show the willingness of the government to commit to the FSB's goals. Only internal power struggles within the Spanish legislator could pose a treat for a speedy reform process.

4.4. Assessment of Soft Law Approach in Particular

The FSB's standards and recommendations are not legally enforceable through a treaty or other legal instruments, thus represent so-called soft law. The recommendations are neither defined in the way they should be implemented, nor how they must be executed. This is both an advantage as well as a disadvantage at the same time. On the one hand, this concept allows considerable leeway for adaptations to the legal framework of each member country, thus avoiding implementation misfits [45]. On the other hand, the softness allows members to only give the impression of implementing the principles whilst they are in fact strongly diverging from them in practice (so-called creative compliance).

4.4.1. Soft Law Framework

Supervision and oversight are of central importance. The peer review process is a correct step on the way, despite requiring approval of the FSB's members before the final report can be published. In practice, soft law sometimes is not fully effective or involves additional pressure to be implemented, as the OECD's internationally agreed standards on tax heavens have demonstrated [46,47]. Mostly a slow implementation process is attributable to weak monitoring and enforcement [48]. After the GFC in 2008 increased international pressure was placed on the countries that signed the OECD standards of transparency during the early 2000s to carry out their commitment, resulting in full compliance of

nearly all countries by the end of 2012 [46,47] and removal of all countries from the OECD's non-co-operative jurisdictions list [49].

The FSB does not define specific rules which must be followed by the member states. However, the published Principles for Sound Compensation Practices represent a small amount of "hardening" of the soft law approach because of their more specific nature. Further detailed rules are introduced through standards set by International Standard Setting Bodies (ISSB). For example the International Accounting Standards Boards (IASB) develops new accounting rules which are subsequently applied in most FSB Member States. However, the IASB has attracted criticism for being too slow to respond to changing circumstances, overly academic and out of touch [50]. Nevertheless, to achieve the FSB's goal of counteracting pro-cyclical behavior new accounting standards in assessing an investment's fair value must be created [51]. The ultimate aim is to build up a buffer which can be used during turmoil in the financial market. However, for this system to function the long term investors must be allowed to use a different accounting valuation method than the market-to-market system [52]. A balanced approach to accounting evaluation standards, distinguishing the different kinds of risk, namely market, credit and liquidity risks needs to be encouraged ([52], p. 159).

In introducing the Principle for Sound Compensation Practices the FSB aims at directly targeting the bank employees' excessive risk taking incentives ([7], p. 687). It aligns the remuneration with long term strategic thinking and prudent risk taking, discouraging the maximization of short term gains.

4.4.2. Soft Law Merits and Risks

Soft law is acknowledged today as a valuable instrument, despite the above mentioned uncertainties [53]. In today's world soft law creates foundation on which many hard laws are based. It allows parties to enter into agreements with varying scope and specificity and to later clarify their exact expectations ([46], p. 284; [47]). As soft law is independent of governmental norm creating institutions it is more flexible thus achieving a higher efficiency and cost-effectiveness. Another often highlighted difference is its ability to react fast to changing circumstances, in contrast to national legislative process, which usually takes very long ([53], p. 12).

This flexibility carries with it the risk of lacking transparency and the potential for decision makers to adopt their own agenda or that of an interest group. Problematic are also the so called "free-riders" which benefit from other parties' expenses into development, implementation and monitoring of codes and standards without investing anything themselves ([7], p. 651). Despite the significant advantages that come with soft law it must fit into the already existing legal framework to ensure its effective application, legitimacy and social acceptance ([48], pp. 324–326).

Being viewed as a recognized partner in the international community by adhering to international soft law encourages compliance because rewards in the form of reduced trade restrictions and access to funds are anticipated. Nevertheless, soft law is subject to the environment it operates in as well as its own design, creating boundaries which can impede the soft laws effectiveness and growth. Therefore, it is necessary to create a link between the existing legal systems and the soft law to give it the transparency and accountability required ([48], pp. 307–09). Establishing a form of dispute resolution in order to avoid overly biased decision making, *i.e.*, through a special panel or body, enables aggrieved parties to challenge the soft law's application.

A host state regulator system is of central importance in preventing regulatory arbitrage. Under it, each unit doing business in a country would be subject to that country's laws and financial oversight. This ensures that no market distortion can occur through an entity registering in a country with lower regulatory standards and subsequently expanding its business overseas into a higher regulated jurisdiction, whilst still participating in the regulatory benefits of being supervised by the home state regulator. The EU has taken steps to achieve uniformity by implementing a single supervisory body within the European Central Bank, responsible for financial supervision of all banks in the euro area [54].

4.5. Importance of Compliance Mechanisms

The powerful members within the FSB can influence the topics to be discussed in the plenary and the focus of the peer reviews. If a member state does not engage in serious discourse as to the concerns raised by other members, these might decide not to support future issues advocated by that member state. Therefore, a degree of balance is maintained. Furthermore, the membership of each country should not be for an infinite period but should require a plenary vote after a set time. This would ensure that Member States that do not comply with the FSB's recommendations could be excluded or their rights in the FSB's decision making process significantly reduced.

4.5.1. Regulatory Options

As reasonable as an exclusion may sound it is not very credible because plenary decisions are reached by consensus thus the member in question would have to vote against itself in order for the decision to be effective. Reducing the membership rights for members who do not show a good faith effort to comply, could add further incentives to honor a commitment made [55].

The G-22 working group suggested that the peer review is most effective when it is conducted among countries with similar levels of financial market development and regulation [56]. Grouping Member States in accordance with these factors would ensure a higher compliance rate whilst allowing for the countries to find appropriate regulation in accordance with the FSB's recommendations but not going so far as to impose an undue burden on them. The peer-review results are published after a consultation with the members. Suggestions have been made to follow the OECD approach and not to fully publicly disclose the assessment in order to maintain an open discussion. Such information sharing and open debate is necessary because of the complexity of the financial regulations and the differing laws in the member state. It would seem to be better if the members worked together to achieve the objectives set by the FSB instead of trying to keep up the appearance of compliance through potentially ineffective regulation.

4.5.2. National Implementation

The final implementation of the FSB's standards will remain with the national financial market supervisors. Thus effective monitoring is necessary in order to identify jurisdictions in which the implementation is slow or lacking. A member country's compliance with the principles and recommendations of the FSB is further encouraged by viewing adherence as fulfilling "best practice" within the international community. This results in a better standing on the international financial markets which in turn affects the funding costs of sovereign debt [57]. Further incentives to follow the

FSB's recommendations are based in the volatility of financial markets and the need for trust in a bank's solvency and financial stability. In jurisdictions not following the FSB principles the legal framework as to a bank's supervision is not clear, thus most international actors are reluctant to do business with them. Banks in such countries nevertheless implement the required standards in order to compete on the international market.

The IMF and the World Bank apply the FSB standards in international reporting and assessment (in particular the FSAP) which further increases the pressure on non-complying countries as they are put into the spotlight by these two powerful institutions [58].

5. Conclusions and Outlook

Economists have been advocating the creation of a world financial authority ([37], p. 122) for regulating the global financial system, or a WTO style model which would allow participation in the decision making process, as well as enforcement mechanisms that ensure effective compliance and uniform application [59]. In order to achieve such a change, countries need to be willing to give up a minimum degree of sovereignty in order to allow such an organization to design effective international regulation, thus raising the minimum regulatory standard of all members in a uniform manner ([25], p. 25). Similar to the WTO, an independent dispute settlement panel could determine whether a member is non-compliant and allow appropriate measures to be implemented. Such measures could include blocking access of companies chartered in the non-complying jurisdiction from trading on the other Member States' markets. This mechanism would act as a strong incentive for the companies to advocate stronger reform measures in their home jurisdiction [60].

However, the reality paints a different picture. The FSB can only support national regulators by giving them the necessary information and analyses to prevent and guard against a future crisis. Due to the strong differences in the market economies in the US, Europe and Asia, every region should choose an appropriate regulatory framework to employ. In setting standards, the FSB highlights areas of concern and advocates change. It currently does not appear to be a good solution to require all countries to fulfill a certain fixed framework of financial regulation, because of their fundamentally varying oversight systems. Nevertheless, higher standards must be pursued and put in place by the developed countries; whereas the developing countries should be granted the necessary breathing space to adjust their systems at a slower pace and in accordance with their individual banking sectors.

Based on the diversity of the G-20 Member States' legal systems, one should think about not advocating a more or less fixed regulatory standard but focus on the desired end result. In doing so, the Member States can address issues and reach the agreed upon target in the manner that is most appropriate to their circumstances. However, special rules such as the capital adequacy requirements imposed on the G-SIFI must be maintained and expanded in order to reduce global risks for financial stability.

The FSB's recommendations should, in the long run, achieve a minimum regulatory framework of the financial sectors in each member state, strengthening oversight and risk identification. Already more progress can be seen than under the FSF based on the tighter structure and better coordination of the FSB. Ahdieh has highlighted that such regular meetings and coordination are essential for the FSB's success in achieving financial stability ([61], p. 546). Nevertheless, regardless of the FSB, the

national regulators would most likely have adjusted their regulatory framework because of market developments and the increased internationalization. However, the FSB has accomplished the formation of a common ground and a coordinated approach to regulation internationally. As all member states share similar issues when it comes to implementing and developing new regulations, the information gains that can be derived from a membership in the FSB and its support should not be underestimated. Looking ahead, the momentum created by the GFC needs to be effectively utilized to complete the implementation of the currently advocated standards and to maintain the FSB's standing as an important international actor. In doing so, the FSB will be more influential than the FSF as it is shaping the expectations of market participants ([61], p. 551).

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Rolf H. Weber was responsible for developing the systematic approach that frames the article. Dominic N. Staiger was primarily responsible for reviewing existing literature and articulating the key themes examined in this work.

Conflicts of Interest

The authors declare no conflict of interest.

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